COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Petition of Fitchburg Gas and Electric Light Company for Approval of Tariffs to Provide Recovery for Costs Associated With Its Obligations to Provide Employee Pension Benefits and Post-Retirement Benefits Other than Pensions	)	**D.T.E. 04-48**

REPLY BRIEF OF FITCHBURG GAS AND ELECTRIC LIGHT COMPANY

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I. INTRODUCTION

Fitchburg Gas and Electric Light Company ("FG&E or "the Company") submits this Reply Brief to the Department of Telecommunications and Energy (the "Department") regarding the Company's proposal to establish an annual pension/PBOP adjustment factor ("PAF") to recover costs associated with the Company's pension and post-retirement benefits other than pension ("PBOP") obligations that are not currently being collected in base rates. The purpose of this Reply Brief is to address the arguments raised by the Attorney General in his Initial Brief ("AG Brief"). As detailed in FG&E's Initial Brief, the record in this proceeding demonstrates that the proposed PAF is a necessary and appropriate ratemaking approach that protects the interest of customers, avoids unnecessary financial harm to the Company and is consistent with the Department's prior orders approving pension/PBOP reconciliation mechanisms. See Boston Gas Company, D.T.E. 03-40 (2003) (the "Boston Gas Order"); Boston Edison Company/Commonwealth Electric Company/Cambridge Electric Light Company/NSTAR Gas Company, D.T.E. 03-47-A (2003) (the "NSTAR Order").

The Attorney General does not dispute that the Company should be able to recover its prudently incurred pension and PBOP costs, nor does he challenge the Department's authority to approve a reconciling rate mechanism for the recovery of such costs. See AG Brief at 2-3, 5. Rather, the Attorney General alleges that the Department should reject or modify the Company's proposal for three reasons: 1) because FG&E seeks to impermissibly pancake base rate increases; 2) because

the Company failed to demonstrate its need for a rate change; and 3) because FG&E's methodology for calculating the PAF overstates the amount that should be recovered. Id. at 1, 4-6. As explained herein, the Attorney General's claims must be rejected because they lack evidentiary support, misconstrue Department precedent and are refuted by the record in this proceeding.[1]

In 2003 the Department announced that the existing conflict between traditional cost of service ratemaking, and accounting and tax requirements, for the funding of pension and PBOP benefits has created a need to consider a new ratemaking approach. Boston Gas Order at 308; NSTAR Order at 6, 28. FG&E's proposed PAF is consistent with Department precedent and provides a ratemaking mechanism that is objective, standardized, fair and workable over the long term. See Exh. FGE-1 at 078. The proposed PAF is necessary to avoid significant harm to the Company and its ratepayers due to the extreme volatility of pension/PBOP obligations. Id. at 076-78. The PAF is modeled after the recovery mechanism approved in the Boston Gas Order and the NSTAR Order and is intended to ensure that customers pay, and the Company recovers, no more and no less than amounts needed to provide pension and PBOP benefits to retired employees. Id. at 078. Rejection of the Company's proposal would be counter productive as it would likely force FG&E into a series of base rate cases to recover the pension and PBOP costs prudently incurred on behalf of its employees. Id. at 077. The

[1] The Company does agree with the Attorney General's last argument that the 2004 and 2005 PAF components should be reconciled in the future. AG Brief at 12. Such a reconciliation will occur by operation of the PAF as proposed. See Exh. FGE-1 at 084-085.

record in this proceeding supports "establishing a forward-looking reconciliation mechanism to avoid the rate increases inherent in a Section 94 case." See NSTAR Order at 45.

II. STANDARD OF REVIEW

The Attorney General's recitation of the standard of review to be applied in this case erroneously suggests that this is a single-issue rate case and misconstrues the Department's decisions in the Boston Gas Order, the NSTAR Order, and Massachusetts Electric Company, D.P.U. 19257 (1977). AG Brief at 2.

A. The Proposed Reconciling Mechanism Is Not Single-Issue Ratemaking

In the NSTAR Order, the Department rejected the Attorney General's assertion that the Company's reconciling mechanism should not be approved because it constituted single-issue ratemaking. NSTAR Order at 18-19. The Department found that the NSTAR proposal was within the sound exercise of the Department's discretion and "something quite apart from and different in kind from single-issue ratemaking." Id. at 18, n. 18 and 19. As in the NSTAR Order, FG&E is not seeking a base rate increase, but is rather proposing to "remove a volatile element from base rates" and recover only its actual costs through an annual reconciliation mechanism. Id.

B. The Department Adopted a New Rate Methodology for the Treatment of Pension/PBOP Costs in 2003

The Attorney General notes that "(t)he Department has not endorsed a specific method for the calculation of pension and PBOP expense for ratemaking purposes", while largely ignoring the Department's analysis and findings in the recent Boston Gas Order and NSTAR Order. AG Brief at 2. Prior to 2003, the Department had treated the intricacies of pension and PBOP expenses on a case-by-case basis, finding it progressively more difficult to determine representative levels of such expenses for inclusion in rates and to settle on a base rate treatment method applicable to all companies. NSTAR Order at 6. Based upon a number of recent filings, however, the Department concluded in late 2003 that "[e]conomic events now persuade us to consider whether and how to develop a consistent practice and treatment of these expenses henceforth, for all jurisdictional gas and electric companies." Id. The Department has subsequently allowed five jurisdictional gas or electric companies to implement a similar reconciliation mechanism for their pension and/or PBOP costs. See Boston Gas Order at 308-309; NSTAR Order at 28, 45.

C. The Company's Proposal Is Not an Emergency Relief Application for Pancaked Rates

The Attorney General's reliance upon Massachusetts Electric Company, D.P.U. 19257, to support his assertion of pancaking is also misplaced. AG Brief at 2-4. In D.P.U. 19257, the Department rejected a request for a base rate increase based upon an overlapping test year; finding a company should not be allowed to

relitigate, a short time later, issues recently decided against the applicant. D.P.U. 19257 at 10. Contrary to the Attorney General's use of that case on brief, the Department also found that the lapse of time between a Department decision in one case, and the filing of a new application for a rate change, is not material. Id. at 5-6. A decision may "be properly followed even the next day by a new application," providing there is no overlap in the test years. Id. at 6.

In this proceeding, the Company is not requesting a base rate increase based upon an overlapping test year. Nor is the Company seeking to relitigate an issue decided against it in its last base rate proceeding. Rather, FG&E is proposing to remove "a volatile element from base rates for annual reconciliation," and recover no more and no less than its actual costs for providing pension and PBOP benefits to its employees. See Exh. FGE-1 at 078; see also NSTAR Order at 18, n. 18. Accordingly, the Company's proposal should not be misconstrued as an emergency relief application requiring a showing of extraordinary circumstances and confiscation. Compare AG Brief at 3-4 with Massachusetts Electric Company, D.P.U. 19257 at 5-6. In this case, as in the Boston Gas and NSTAR proceedings, the Company seeks "reasonable, but unusual relief from the effects of very unusual economic conditions and unforeseen consequences those conditions lead to under (the) FASB rules." NSTAR Order at 44.

D. The Department Has Established a Standard of Review for Pension/PBOP Reconciliation Mechanisms

In the Boston Gas Order, the Department applied a two part standard of review. See Boston Gas Order at 309. First, the Department considered whether the Company has demonstrated a need for a reconciling mechanism. Id. at 308-309. In applying this standard, the Department found Boston Gas had demonstrated a need because it was required, under SFAS 71, to recover its pension deferrals in a reasonable period of time, or face significant adverse financial consequences resulting from a required write-off of its Additional Minimum Liability ("AML"). Id. at 308-309. Second, the Department considered whether the company had established the three factors previously used by the Department in determining that an item should be recovered through a reconciling mechanism. Id. at 309. Under that test, the Company had to demonstrate:

1) the magnitude and volatility of the pension expense;

2) the role of accounting requirements, rather than the Company's actions, in the pension expense volatility; and

3) the effectiveness of the reconciling mechanism in avoiding the negative effects of the pension expense volatility.

Id.

As detailed in its Initial Brief, and herein, FG&E has demonstrated its need for the PAF because under SFAS 71 it must recover pension and PBOP

deferrals in a reasonable period of time or face an extraordinary write-off that would have detrimental consequences for the Company and its customers. Exh. FGE-1 at 076. FG&E has also shown that its proposal is consistent with Department precedent because of the magnitude and volatility of its pension and PBOP expense, because that expense is beyond the Company's control and because the proposed PAF will allow FG&E to avoid the negative effects of the pension expense volatility (i.e., a significant reduction in equity or a series of base rate proceedings). Exh. FG&E-1 at 069-078. Accordingly, the Department should approve FG&E's proposed PAF because it meets the standard of review established by the Department in 2003.

III. ARGUMENT

A. FG&E's Proposed PAF Is Not an Impermissible "Pancaking" of Base Rate Increases

FG&E's proposed PAF does not constitute a "pancaking" of base rate increases because it is not a request to increase base rates, nor does it involve overlapping test years. See AG Brief at 3-4. As the Department has recognized, a pension/PBOP reconciliation mechanism does not constitute single-issue base ratemaking, but rather involves the removal of a volatile element from base rates for annual reconciliation. NSTAR Order at 18, n. 18. The test year in the Company's last base rate case was 2001 and the Company is not seeking to relitigate any issues decided against it regarding that prior test year. See Tr. (8/17/04) at 27; Exh. FGE-1, at 079-81.

In asserting that the Company's request is an impermissible "pancaking," the Attorney General confuses the facts and misapplies the law. The Attorney General asserts that FG&E's request constitutes pancaking under Department precedent because "(t)he Company asks to recover additional base rate costs that it deferred just days after the beginning of the rate year established in its last base rate case." The very precedent cited by the Attorney General, however, demonstrates that FG&E's request is not an illegal pancaking because it only prohibits overlapping test years, not changes to rates in a subsequent rate year. Massachusetts Electric Company, D.P.U. 19257 at 5-6. In D.P.U. 19257 the Department noted that the lapse of time between a rate case order and a new application for a rate change was not material, as long as there was not an overlapping test year. Id. (citing to Boston Edison Company, D.P.U. 18515 (allowing filing of new rate case 17 days after decision in a prior case)). Absent the use of the same test year, a company may file a new request "even the next day" after a Department rate order. Id. at 6.

In this proceeding, FG&E is proposing a new ratemaking methodology, based upon Department precedent, to resolve the incongruity between ratemaking, tax and accounting rules regarding pension and PBOP expenses. FG&E was first advised by its actuaries and accountants of the potential of a significant write-off resulting from the declining capital markets and interest rates, and the operation of certain accounting rules, in mid-October, 2002. D.T.E. 02-83 at 2. FG&E was not aware of a known and measurable change to its pension/PBOP expenses at the

close of the record in D.T.E. 02-24/25. Compare D.T.E. 02-83 at 2 with D.T.E. 02-24/25 at 2. Indeed, if the Company did have facts to support such a change during the course of the proceeding in D.T.E. 02-24/25, it would have had no reason not to have raised them, as the Department at that time had not provided specifically for the deferral of such costs, much less for the recovery through a reconciling mechanism.

The Department has approved FG&E's requests to create a regulatory asset for its AML and to defer the difference between the level of pension and PBOP expenses that are included in FG&E's current base rates and amounts that are required to be booked in accordance with SFAS 87 and SFAS 106, since the effective date of its last rate case. See D.T.E. 02-83 at 2-3; D.T.E. 03-131 at 4. In this proceeding, FG&E is seeking to recover those deferred amounts, which do not include amounts from the 2001 test year, but do include amounts for calendar year 2003, through a reconciling mechanism consistent with the Department's recent precedent. See Exh. FGE-1 at 079-81.

The Attorney General's proposed disallowance of the Company's prudently incurred 2003 pension and PBOP costs would have a material impact on FG&E. The proposed disallowance would require the Company to write off that portion of its regulatory asset related to the 2003 pension and PBOP deferral and take a charge to earnings in that amount ($284,008).[2] See Exh. FGE-1 at 077;

[2] The after tax charge to write off FG&E's regulatory asset related to its 2003 Pension/PBOP deferral would be $284,008, calculated as follows: the sum of the "Unamortized Reconciliation Deferral at 12/31/03," per Exh. DTE-9, line 1 of Schedule LMB-1 (Revised 8-12-04), of $412,510 and carrying charges on that amount at 11.10%, per Exh. DTE-9, line 8 of Schedule LMB-1

Exh. DTE 9, Sch. LMB-1, (Revised 8-12-04). Such a write-off, net of tax, would be equal to more than 10%[3] of the total annual electric and gas distribution return on equity authorized by the Department in the Company's base rate case ($2,722,700).[4] A disallowance of FG&E's 2003 prudently incurred pension and PBOP expense would be particularly inequitable given the pension and PBOP cash funding made by FG&E in 2003 for which FG&E has not sought, nor received, base rate recovery.

In 2003, FG&E made a cash contribution of $375,000 to its pension trusts, while no pension expense was included in its last base rate case. Compare Exh. DTE-10, Attachment (1) (showing 2003 "Pension Plan Contributions By Company" for electric ($219,113) and gas ($155,888) divisions) with D.T.E. 02-24/25 at 112 (authorizing zero pension expense in cost of service). FG&E also made cash contributions in 2003 of $777,198 for its PBOP expenses, $232,169, or approximately 43% more than the PBOP expense collected in FG&E's base rates. See Exh. DTE-9, Schedule LMB-1 (Revised 8-12-04). A disallowance of the 2003 pension and PBOP costs would also be inconsistent with the policy objectives in establishing a reconciliation mechanism for pension/PBOP costs,

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(Revised 8-12-04) of $45,789. That sum of $458,299, net of taxes at 38.03%, per Exh. DTE-9, line 10 of Schedule LMB-1 (Revised 8-12-04), of $174,291), equals the write-off, $284,008.

[3] The numerator is $284,008 per footnote 2 above and the denominator is $2,722,700 per footnote 4 below.

[4] In D.T.E. 02-24/25 the Department authorized FG&E to collect $2,722,700 in combined gas ($26,736,660 x 4.08% = $1,090,856)(pp.293-4) and electric ($39,996,184 x. 4.08% = $1,631,844) (pp. 304-5) distribution income (rate base x weighed cost of equity).

because it would not allow FG&E to avoid the adverse effects of the volatility of such costs. See Boston Gas Order at 26-27.

Contrary to the Attorney General's contention, FG&E's circumstances are not analogous to the Department's denial of recovery of NSTAR's pension and PBOP cost during their rate freeze period. See AG Brief at 4, n. 2. In D.T.E. 99-19, the Department approved a rate plan that included a voluntary four year rate freeze in distribution rates as part of a merger. Boston Edison Company, D.T.E. 99-19 at 22-27. Under the rate plan the companies could seek recovery of additional costs during the rate freeze for certain exogenous factors. Id. In the NSTAR Order the Department rejected application of the pension/PBOP reconciliation mechanism during the last eight months of the rate freeze, because the pension/PBOP costs did not qualify as exogenous costs under the rate plan and because NSTAR had voluntarily agreed to the rate freeze. NSTAR Order at 32-33.

FG&E seeks recovery of the 2003 pension and PBOP amounts in order to obtain "reasonable, but unusual relief from the effects of ... very unusual economic conditions and the unforeseen consequences those conditions lead to under [the] FASB rules." See NSTAR Order at 44. Allowing FG&E to recover its 2003 pension and PBOP deferrals, from the effective date of its last rate case, is, in fact, consistent with the Department's decision to allow NSTAR to recover its pension and PBOP deferrals from the date its rate freeze ended, including recovery for the last four months of 2003. See NSTAR Order at 32-33. As

FG&E was not subject to a rate freeze in 2003, it should be allowed recovery for all of its 2003 pension and PBOP deferrals.

B. FG&E Has Demonstrated Its Need for the Proposed PAF to Avoid Severe Financial Harm

Without citation to any record evidence, the Attorney General makes a bare assertion on brief that the Company did not establish a need for its rate proposal. AG Brief at 5. The record evidence demonstrates that FG&E is subject to the requirements of SFAS 71, which requires that there must be an assurance that regulatory assets created by the deferral of pensions and PBOP costs are probable of recovery. See FG&E Exh. 1 at 071; Exh. DTE-3 at 6; Tr. (8/17/04) at 96-97. The Company proposes to recover its pension and PBOP deferrals through the proposed PAF over three years. Tr. (8/17/04) at 10. The record also shows that if the Company is not allowed to recover its pension and PBOP deferrals in a reasonable amount of time, it will be required to take an extraordinary charge to equity of $4.2 million (2003) which is equal to approximately 15% of FG&E's total equity. Exh. FGE-1 at 076. Also, the additional expense amount that would have been recognized of approximately $2.2 million would constitute an increase of approximately $1.5 million over the amount collected by FG&E in its base rates for pension/PBOP costs. Id. In 2003, these charges would have represented approximately 15% of the total amount of O&M expenses collected by FG&E in its base rates. Id.

The record further demonstrates that if FG&E were required to take a significant charge to equity, or was exposed to potentially volatile pension/PBOP

expense for which it was not guaranteed rate recovery, the Company's credit rating would be adversely affected. Id. at 077. As a result, FG&E's ability to borrow funds would be diminished and its cost for raising capital would be increased, resulting in higher costs to serve customers. Id. Consistent with the Department's findings in the Boston Gas Order and the NSTAR Order, the adverse financial impact upon the Company would translate into detrimental impacts upon customers, including increased rates, more frequent rate cases and the potential for deterioration in service quality from a financially strapped utility. Id.; NSTAR Order at 25-27.

C. The Attorney General's Assertion that FG&E Has Failed to Disclose Facts Is a Distortion of the Record

The Attorney General's assertion that FG&E failed to disclose pertinent information regarding the 2003 reorganization is based upon a selective use of incomplete facts to create, by innuendo, the impression of improper conduct. AG Brief at 5. Accordingly, it must be rejected by the Department.

The Attorney General's selective reference to the record evidence distorts the alleged savings amount from Unitil's 2003 reorganization attributable to FG&E and the impact upon the Company, and ignores contrary evidence. Id. The Attorney General's claim of $920,000 of annual decreases in costs due to the Unitil reorganization is mere conjecture and does not even disclose the lower savings estimate provided in response to his record request. Compare AG Brief at 5, n. 3 with RR-AG-1 and Attach. RR-AG-1(2). The Attorney General also fails

to note that reorganization savings in 2003, the rate year, were offset by $622,885 of severance and reorganization payments. RR-AG-1, Attach. RR-AG-1(2).[5]

The Company did not note the reorganization savings in its December 12, 2002 request for an accounting order because there were no net O&M savings in 2003 and O&M cost levels were not relevant to the Company's request. The record evidence shows that the expected cost savings from the reorganization were dwarfed by off-setting increases in Unitil's total O&M in 2003. As shown in the Attorney General's Exh. 6, Unitil's O&M expense increased by a total of $2.2 million in 2003, or 11.2%, net of the operating expense savings of approximately $1.0 million resulting from the reorganization. Exh. AG-6 at 20. Thus, Unitil's O&M increased by a total of $3.2 million, before netting out the $1.0 million reorganization savings. Id. Given that the O&M cost increases were three times the amount of the reorganization savings, there was no net cost decrease to report to the Department.[6]

The Company's December 12, 2002, letter to the Department was narrowly focused on the incongruity between the ratemaking and accounting rules applicable to pension costs and quantifying the potential increases and write-offs associated with those costs. See D.T.E. 02-83. The Company's request sought

[5] The Company's estimate of $498,693 of expense spending savings, and $340,669 of capital spending savings, was offset in 2003 by $622,885 of severance and reorganization payments, thus producing only $216,477 of possible net spending savings for 2003. RR-AG-1, Attach. RR-AG-1(2).

[6] While the exhibit only addresses Unitil's consolidated expenses and savings, we would expect the ratio of cost increases to savings to be similar for FG&E.

approval to record its AML as a regulatory asset in order to avoid a significant write-off of equity. This potential write-off of equity would have occurred absent an order from the Department and regardless of the current level of the Company's O&M expense. Id. Accordingly, even though Unitil was experiencing a significant net increase in O&M expenses, the Company did not attempt to quantify or discuss any other cost increases or decreases. Id. Even if FG&E experienced a net O&M cost reduction (which it did not) it would not have eliminated the need for the requested relief nor mitigated the potential $4.2 million (2003) reduction in equity. The Attorney General's claim that the Company acted improperly by failing "to inform the Department of coincident cost reductions that eliminate the need for the deferral" is, therefore, contradicted by the record evidence and must be rejected.

The Attorney General's inference that the Company was trying to hide cost savings from the Department is contradicted not only by evidence of offsetting O&M cost increases, but also by evidence that Unitil and FG&E have continued to make significant investments in the Company. In 2003, Unitil made a $6 million equity contribution to FG&E, to strengthen the financial structure of the Company and to provide funds to support capital projects, such as an aggressive cast iron replacement program and upgrades to major distribution facilities, as well as to support its increasing costs, including pension and PBOP funding obligations for the Company's employees. See Tr. (8/17/04) at 106. Thus, the appropriate inference that should be drawn from FG&E's and Unitil's actions in

late 2002 and 2003 is that the Companies engaged in good utility practice by pursuing a management restructuring to control costs in the face of rising O&M expense and a slow economy. FG&E also took appropriate action to seek an expedited accounting order from the Department to avoid a potential $4.2 million (2003) reduction in equity, while continuing to fund capital improvements to ensure the safety and reliability of its systems. See D.T.E. 02-83; D.T.E. 03-131.

The Attorney General continues his unwarranted attacks on the Company's credibility by claiming that FG&E failed to update a particular data request in D.T.E. 02-24/25 and disclose 'audits' related to the 2003 reorganization. AG Brief at 6.[7] The evidentiary hearings in D.T.E. 02-24/25 ended in September 2002 and final briefs were submitted in October, 2002. D.T.E. 02-24/25 at 2-3. In October 9, 2002, FG&E filed a Motion to Admit Post-Hearing Evidence and the Attorney General filed an opposition, claiming the evidence was untimely. Id. at 10-11.

The record in this case shows that Unitil first considered a potential reorganization in November 2002 and that the reorganization plan was approved by the Unitil Board of Directors on December 12, 2002, for implementation in January 2003. RR-AG-1. The Company's response in June 2002, to the Attorney

[7] In making his spurious claim, the Attorney General relies upon non-record evidence and asks the Department to incorporate by reference Exhibit AG-1-8 from D.T.E. 02-24/25. FG&E affirms the accuracy of its response. Moreover, FG&E objects to introduction of this evidence at this time because it does not have the opportunity to present evidence to explain why the response is accurate or introduce other relevant facts. The Attorney General failed to file a motion to submit this information response as required by 220 C.M.R. 1.11(8). The Attorney General also failed to show that the introduction of this post-hearing evidence is warranted because it was previously unknown, is new or is extraordinary. See Milford Water Co., D.P.U. 92-101, at 36 (1992); Bay State Gas Co., D.P.U. 98-81, at 45 (1989). If the Department does allow the Attorney General's request, the Company asks that the Department also incorporate in this record the fact that the data response was filed on June 28, 2002, a fact omitted by the Attorney General.

General's request for all "audits" was accurate at that time and through the close of the record in D.T.E. 02-24/25. Even if the Attorney General construes the reorganization plan as responsive to his requests, the record demonstrates that the plan was issued on December 12, 2002, after both the close of the record and the Department's decision in D.T.E. 02-24/25. By failing to introduce AG-1-8 in the evidentiary phase of the hearing, the Attorney General has deprived the Company of an opportunity to respond on the record to his claims, and provide additional evidence regarding its response and the timing and development of the 2003 reorganization. Accordingly, the Attorney General's claim should be rejected as unsupported by the record evidence and untimely. See Fitchburg Gas and Electric Light Company, D.P.U. 19084 at 6 (1977).

D. FG&E's Treatment of the Annual Amortization of Its PBOP Transition Obligation Is Appropriate

The Attorney General's assertion that FG&E should be required to capitalize a portion of the annual amortization of its PBOP transition obligation in calculating its PAF is erroneous and lacks evidentiary support. AG Brief at 6-7. As shown on Exh. FGE-1, Schedule LMB-2, FG&E reduced the per book PBOP expense by the portion applicable to the transition obligation before calculating the amount of PBOP expense that is chargeable to construction overheads. Exh. DTE-11. The amortization of the transition obligation is a component of the annual PBOP expense which relates to the recognition, over time, of the difference between the accounting for PBOP expenses prior to the adoption of SFAS 106 under the "pay as you go" or cash basis, and the accounting for PBOP

expenses at and since the adoption of the full accrual basis for accounting under SFAS 106. Id. The transition obligation amortization amount is separated from the amounts chargeable to current construction overheads to avoid charging current construction projects for prior period costs. Id.

FG&E is currently capitalizing 41.17% of its labor-related benefit costs to construction overheads. See Exh. FGE-1, Sch. LMB-2, line 2. The Attorney General's request that the Department require the capitalization of additional costs is inappropriate and unsupported by the record. Such a requirement could result in an unnecessary over-allocation to capital by FG&E and the unwarranted charging of prior period costs to current construction overheads. Id.

E. FG&E's Treatment of the Service Company Pension/PBOP Accruals Is Not Unfair to Ratepayers

The Attorney General asserts that the Company's inclusion in the PAF of pension and PBOP costs associated with Unitil Service Corp. ("Service Company") is unfair because the Company does not credit any amount of pension and PBOP accruals for the Service Company to the balance earning carrying charges. AG Brief at 7-8. The Attorney General's claim is off the mark, however, because it fails to recognize that none of the Service Company's assets or liabilities is allocated to FG&E for inclusion on its balance sheet or to be used in the development of FG&E's ratebase and cost of service for ratemaking purposes. See Tr. (8/17/04) at 105.

Each month, the Service Company issues a bill to FG&E and its other subsidiaries for the services it provides, and the subsidiaries record those charges on their books as operating expenses. Id. However, pension accrual amounts are only reflected on the Service Company's balance sheet, and are not billed or recorded on FG&E's balance sheet. Id. The Service Company does not allocate to its subsidiaries any assets and liabilities. For ratemaking purposes, the Service Company's assets and liabilities are not included in the computation of FG&E's rate base, or cost of service. See generally D.T.E. 02-24/25 at 117-1221.

Because the Service Company's assets or liabilities are never allocated to FG&E, the Company's proposed treatment of the PBOP/Pension accrual amounts is not asymmetrical. FG&E's proposal is consistent with the way that all Service Company assets and liabilities are treated for ratemaking purposes. See D.T.E. 02-24/25 at 177 (2002). Contrary to the Attorney General's assertions, the collection of the Service Company's pension expenses which are included in FG&E's O&M does not result in the collection of costs associated with the Service Company while depriving customers of any offsetting benefits. The Service Company pension and PBOP accrued liabilities represent the Service Company's obligation to provide pension and PBOP benefits to its employees and retirees, not amounts owed to FG&E's ratepayers.

F. Recovery of Carrying Charges Associated with FG&E's Prepaid Pension/PBOP Costs Is Equitable and Consistent with Department Precedent

The Attorney General argues that the Department should deny FG&E recovery of the carrying charges associated with the net amount of prepaid/accrued pension and PBOP costs, because the Company did not flow pension income through to customers. AG Brief at 9. The Attorney General's position is contrary to Department precedent. See NSTAR Order at 37. His argument is also illogical, as there is no nexus between pension expense or income and the purpose of carrying charges.

As the Department recognized in the NSTAR Order, the purpose of carrying charges is to compensate utilities for the time value of money due to the delay in rate recovery of significant expenditures. NSTAR Order at 37. The Department held:

> Because of the benefits which inure to ratepayers from these payments and the extraordinarily high prepaid balances arising from forces at work in the economy at large and outside the Companies' control, the Companies should no longer absorb the money costs on these significant cash outlays. Accordingly, we will allow carrying charges to be recovered from customers on prepaid pension and PBOP balances.

Id. Because in its last base rate case, FG&E reduced its pension income to zero, the Attorney General illogically asserts that the NSTAR precedent is not applicable to FG&E. AG Brief at 9. However, the Department's ruling in the NSTAR Order was unequivocal, and not based upon the inclusion or exclusion of

pension income. NSTAR Order at 37. The fact that FG&E removed the pension income in the test year from its trust fund is completely irrelevant to whether carrying charges should be allowed in this case. Neither NSTAR nor Boston Gas reduced the pension income that they received from their trust funds to zero because they had expenses and were making contributions.

The Department should reject the notion that FG&E should be penalized because its pension expense in the test year was lower than these other companies. Moreover, as Exh. DTE 10 shows, over the past five years, the Company experienced periods of pension expense and periods of pension income. Exh. DTE-10, Attach (1). Thus, FG&E's pension income in the test year should not be viewed in isolation and used by the Attorney General as an excuse to deprive the Company of recovery of its legitimate carrying charges.

G. The Company's Allocation of Pension and PBOP Costs Between Distribution and Transmission Is Appropriate

The Attorney General erroneously states that FG&E failed to allocate a portion of the PAF increases to the transmission business, in violation of the Department's directive in FG&E's last rate case. AG Brief at 9-10, citing DTE 02-24/25 at 234-235 (2002). As explained in Exh. AG-4, FG&E appropriately reflected an allocation of its pension and PBOP costs to the transmission function in the development of the rate. With respect to expenses, the amount of pension and PBOP costs determined to be recovered in base rates includes the amounts allocated to transmission based upon the test year cost of service in FG&E's last

rate case. Exh. AG-4; Exh. FGE-1 at 25. As a result, the amount of Pension and PBOP costs allocated to transmission is deducted in determining the PAF.

With respect to prepaid pension/PBOP balances, FG&E would exclude these balances in its transmission cost of service (until it conducts a fully allocated cost of service study in its next base rate case). FG&E submits that its proposed allocation methodology, until its next rate case, is administratively efficient and is consistent with the Department's directive in D.T.E. 02-24/25 and with Section 1A(b)(1) of chapter 164.

H. The Company's Assumed Return on Assets for Its Pension/PBOP Trust Funds Is Distinguishable from FG&E's Allowed Return on Equity and Is Not Unfair to Customers

The Attorney General's asserts that the difference between the assumed return on assets ("ROA") used in the Unitil's pension and PBOP trust funds, and FG&E's allowed rate of return on common equity ("ROE"), is unfair to customers because the ROA is lower. AG Brief at 10-11. This apples-to-oranges comparison again misconstrues the record and fails to recognize the differences between, and the purposes of, these two rates of return. The Attorney General's argument should also be summarily rejected because it is an attempt to introduce testimony on brief by cobbling together unrelated calculations from a risk premium analysis in a prior case that the Attorney General opposed and the Department rejected. Compare AG Brief at 11-12 with D.T.E. 02-24/25 at 222, 228.

The basic premise of the Attorney General's argument is erroneous because it compares a consolidated return on assets, including debt and equity, to an unbundled return on equity. AG Brief at 11. The Attorney General claims that the Company's proposal is unfair to ratepayers because it uses an ROA of 8.75% and a higher ROE of 10%. AG Brief at 10-11; RR-AG-3 (noting Company's 2003 ROA of 8.75%). The argument is fundamentally flawed, however, because the 8.75% ROA is a consolidated return for both debt and equity investments, while the ROE reflects only a return on equity. Compare Tr. at 65 with D.T.E. 02-24/25 at 294, 305. Assuming, *arguendo*, that there is some validity to comparing FG&E's ROA to FG&E's allowed returns, the appropriate comparison would be between the consolidated ROA and the rate of return authorized on FG&E's rate base. This comparison demonstrates no 'unfairness' to customers, because the consolidated ROA of 8.75% is in fact higher than FG&E's authorized return on rate base of 8.5%.[8] See D.T.E. 02-24/25 at 294, 305. Accordingly, the Attorney General's 'fairness' argument is erroneous.

The Attorney General also fails to recognize the fundamental differences between the purposes and establishment of a regulated ROE and a pension plan's ROA. The purpose of an allowed rate of return on equity is, in the context of rates for service, to provide a company an opportunity to compensate its equity investors for the risk they assume when they purchase equity shares. See

[8] The Company and its advisors determine a total ROA, and there is no break out of a debt or equity component. RR-AG-3. Applying the Attorney General's logic to the appropriate numbers, however, would show that because FG&E's ROE (10%) is 1.5 percent larger than its consolidated return (8.5%), then the equity component of the ROA should be assumed to be 1.5% higher than the consolidated ROA (8.75%) or 10.25%.

Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679, 692-93 (1923) ("Bluefield"); Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 603 (1942) ("Hope"). On the other hand, the purpose of the expected rate of return on pension plans is to provide an assumption by which a company's actuaries and accountants approximate the value of the pension plan assets, as part of the overall process regulated by SFAS 87 and related requirements, to ensure that current employees will receive their earned pension plan payments when they become due. See generally Exh. DTE-1, Attach. (1) at 3-5.

The Department has long held that the standard for determining the allowed rate of return on common equity for a jurisdictional utility was established by the United States Supreme Court in the Bluefield and Hope decisions. D.T.E. 02-24/25 at 229. Under that standard the Department has found that an allowed return on common equity should preserve the Company's financial integrity, should allow it to attract capital on reasonable terms and should be comparable to returns on investments of similar risks. Id. Applying its judgment, based upon its analysis of various empirical models, the Department determines, in the context of a full base rate proceeding, a rate of return that is in a reasonable range to achieve the above-stated objectives. Id. at 229-230.

The standard and process for determining the expected ROA for a pension plan assets is established under SFAS 87 and is clearly distinguishable from the Department's determination of a return on equity for a public utility. Compare

D.T.E. 02-24/25 at 229-230 with AG-RR-3. SFAS 87 requires that the ROA be determined based on the expected long-term rate of return on plan assets. Exh. DTE-1, Attach. 1 at 12 and 14. Factors considered in determining the ROA include: 1) recent ROA directional changes and related assumptions used by other plan sponsors having similar portfolios; 2) historical pension plan portfolio performance; 3) current market returns and interest rate levels; and 4) inflation expectations. AG-RR-3.

Based upon advice of its actuaries and accountants, and applying the requirements of SFAS 87 and the above-stated factors, the Company determines an appropriate ROA for the plan. Id. That analysis is based on investment yields of equities and bonds over a 30-year horizon and includes benchmarking against rates used by other companies. Tr. (8/17/04) at 53. It is also based on a conservative investment strategy in bonds and equity securities such as the Standard and Poors 500, but does not include venture capital investments. Id.

The ROA is a composite figure for expected long-term returns on debt and equity investments. Tr. (8/17/04) at 65. It reflects a conservative approach for long term investments appropriate to a pension plan. Id. at 66. The ROA used by Unitil in 2003 was 8.75%, and reflected a decrease of 50 basis points from 2002 (9.25%) to reflect a downturn in the expected long-term return on assets resulting from the general economic environment. Id. at 65.

The Attorney General's attempt to 'calculate' one portion of the ROA for FG&E, a return on equity securities, based upon the risk premium analysis from

FG&E's last rate case is nonsensical. AG Brief at 11-12. This apples-to-oranges comparison is unsupported by any expert testimony and relies upon the results of a financial model which the Attorney General opposed and the Department does not rely on. See D.T.E. 02-24/25 at 238.[9] The risk premium analysis for determining an ROE for FG&E is not comparable to the process of determining an ROA for Unitil's pension trust. The risk premium analysis does not reflect the expected long-term gains through a conservative investment strategy, nor does it involve benchmarking against the investment returns for other pension plans.

The Attorney General's suggestion that the Department reduce FG&E's return on equity is also unsubstantiated, because it is based upon his erroneous assumption that the ROA is unfair to customers and because "he has done nothing more than assert a point without proving it". Compare AG Brief at 10-12 with NSTAR Order at 38. The Attorney General's proposal regarding a reduction to equity must be rejected because events of extraordinary magnitude but low probability are not incorporated or allowed for in ordinary rate cases. NSTAR Order at 38-39. Thus, as the Department found in the NSTAR Order, it would not be appropriate to reduce FG&E's ROE given that the proposed rate mechanism was the result of theoretically conceivable, but hardly likely, adverse impacts resulting from the downturn in the financial markets and the operation of SFAS 71, 87, and 106. NSTAR Order at 39.

[9] FG&E's expert only presented the cited analysis for comparative purposes and did not ask the Department to establish FG&E's ROE based on these studies. D.T.E. 02-24/25 at 228.

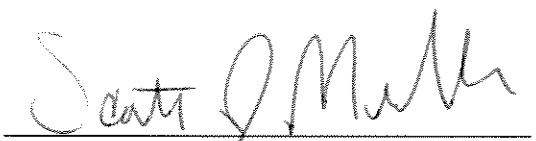
IV. CONCLUSION

For the reasons set forth herein, and in the Company's Initial Brief, FG&E respectfully requests that the Department approve the proposed tariffs for the Pension/PBOP Adjustment Factor, as set forth in Exhibit FGE-1, pages 001-0026.

Respectfully submitted,

FITCHBURG GAS AND
ELECTRIC LIGHT COMPANY

By its Attorneys,



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